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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1992

Henry Harper, *et al.*, *Petitioners*

v.

Virginia Department of Taxation, *Respondent*

ON WRIT OF CERTIORARI TO THE
SUPREME COURT OF VIRGINIA

AMICUS CURIAE BRIEF
BY THE STATE OF ARKANSAS
IN SUPPORT OF RESPONDENT

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTEREST OF AMICUS CURIAE 1

SUMMARY OF ARGUMENT.....2

ARGUMENT.....3

THE VIRGINIA SUPREME COURT CORRECTLY CONCLUDED THAT *DAVIS V. MICHIGAN* SHOULD NOT APPLY RETROACTIVELY.

I. When decisions are not consistent with prior law and retroactive application is not presumed, retrospective application must be closely scrutinized. 3

II. Based on the tests set forth in *Chevron Oil Co. v. Huson, Davis* should not be applied retroactively.

A. *Chevron* Factor Number One 5
B. *Chevron* Factor Number Two 6
C. *Chevron* Factor Number Three 8

III. Remedies are determined by state law and prospective relief is constitutionally sufficient.....13

CONCLUSION.....15

TABLE OF AUTHORITIES

Page

CASES:

Allied Signal, Inc. v. Director, 112 S.Ct. 2251 (1992) ...14

American Trucking Ass'ns v. Scheiner,
483 U.S. 266 (1987) 4, 5

American Trucking Ass'ns, Inc. v. Smith,
495 U.S. ___ , 110 L.Ed.2d 148 (1990) ..... *passim*

Barker v. Kansas, 503 U.S. ___ , 118 L.Ed.2d 243,
112 S.Ct. 1619 (1992).....1

Chevron Oil Co. v. Huson, 404 U.S. 97
30 L.Ed.2d 296, 92 S.Ct. 349 (1971) ..... *passim*

Davis v. Michigan Department of Treasury,
489 U.S. 803 (1989) ..... *passim*

James B. Beam Distilling Co. v. Georgia,
501 U.S. ___ , 115 L.Ed.2d 481 (1991) 3, 4, 13, 14

*McKesson v. Division of Alcoholic Beverages &
Tobacco*, 496 U.S. 18, 110 L.Ed.2d 17 (1990) 4, 13

Pledger v. Bosnick, et al., 306 Ark. 45, 811 S.W.2d
286, *pet. for cert. pending* No. 91-375 .....1, 10, 15

Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992) 14

Streight v. Ragland, 280 Ark. 206,
655 S.W.2d 459 (1983) 9, 10

TABLE OF AUTHORITIES

Page

MISCELLANEOUS:

1975 Ark. Acts 683.....8
1977 Ark. Acts 793.....9
1985 Ark. Acts 486.....10
1987 Ark. Acts 521.....10
1989 Ark. Acts 512.....10
1989 Ark. Acts 27 (3d Ex. Sess.) 5, 7, 10
1989 Va. Acts c.3 (Spec. Sess. II) 5

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HENRY HARPER, *et al., Petitioners*

v.

VIRGINIA DEPARTMENT OF TAXATION,
Respondent

AMICUS BRIEF BY THE STATE OF ARKANSAS IN SUPPORT OF RESPONDENT

INTEREST OF AMICUS CURIAE

Pending before this Court on a petition for certiorari is an Arkansas case, *Pledger v. Bosnick*, 306 Ark. 45, 811 S.W.2d 286 (1991), *pet. for cert. pending* No. 91-375, ("Pledger") the outcome of which, if *Davis v. Michigan Department of Treasury*, 489 U.S. 803, (1989) ("Davis") is applied retroactively, will have a devastating effect upon the citizens of the State of Arkansas.

Two basic issues remain in *Pledger* after this Court's decision on the military retiree question in *Barker v. Kansas*, 503 U.S. ___, 118 L.Ed.2d 243, 112 S.Ct. 1619 (1992). If the decision here is to apply *Davis* prospectively only, consideration of the issue of whether the doctrine of intergovernmental tax immunity is to be extended to retirees who had been employed with other states and their political subdivisions will not be necessary.

If *Davis* is applied retroactively and the doctrine of

intergovernmental immunity is extended, Arkansas could be required to refund in excess of $50 million. The potential refund as of May 15, 1992 was $44.7 million, with a monthly interest accrual of $261,587.00.

As will be discussed further *infra*, the economic realities of this potential refund situation will adversely affect current and future generations of Arkansans.

SUMMARY OF ARGUMENT

Amicus urge the affirmance of the decision of the Virginia Supreme Court to apply this Court's *Davis* decision nonretroactively. *Davis* established a rule which diverged from prior interpretation of federal law. Retroactive application of this decision will frustrate the purposes of intergovernmental tax immunity and will work a substantial hardship on Respondent and other states including Amicus. Nonretroactive application will provide Petitioners relief that is constitutionally sufficient.

ARGUMENT

THE VIRGINIA SUPREME COURT CORRECTLY CONCLUDED THAT *DAVIS V. MICHIGAN* SHOULD NOT APPLY RETROACTIVELY.

I. When decisions are not consistent with prior law and retroactive application is not presumed, retrospective application must be closely scrutinized.

Retroactive application of a decision of this Court is usually a given. *See James B. Beam Distilling Co. v. Georgia*, 501 U.S. ___, 115 L.Ed.2d 481, 487 (1991). From a jurisprudential standpoint, automatic retroactivity advances the need for finality. *Id.* at ___, 115 L.Ed.2d at 492-93. Indeed, it is often implicit, yet obvious, that a decision of this Court is binding on all cases under review at the time of decision and in the future. *Id.* at ___, 115 L.Ed.2d at 490.

Nevertheless, the Constitution contemplates, and this Court has determined, that retroactivity is not an absolute. *Id.* at ___, 115 L.Ed.2d at 494 (White, J. concurring); *American Trucking Ass'ns v. Smith*, 495 U.S. ___, 110 L.Ed.2d 148, 168 (1990). Although this issue is rarely questioned in the civil context, there are situations involving a break from prior precedent or a decisional trend upon which third parties reasonably relied. The question of retroactive application is present because either the parties to the original action did not litigate the retroactivity issue or the Court did not explicitly or implicitly state that the decision applied retroactively. *Id.* In other words, the new rule is unexpected and could seriously affect either a party or a nonparty in retrospect. The result of retroactive application under these circumstances is a legal obligation for acts that were, at their occurrence, valid.

When retroactivity is not discussed, a question of choice of law arises or remains unanswered. It involves a choice between retroactivity and nonretroactivity which must be decided before a state can fashion a remedy consistent with Due Process and state law. *See Beam* at ___ , 115 L.Ed.2d at 487-88; *Smith* at ___ , 110 L.Ed.2d at 158-59; *McKesson v. Division of Alcoholic Beverages and Tobacco*, 495 U.S. ___ , 110 L.Ed.2d 17, 45 (1990).

It is also important, based on Petitioner's argument, to note what the federal question is not. It is not a question of remedy. For "state courts have the initial duty upon remand of crafting appropriate relief in accord with both federal and state law." *McKesson* at ___ , 110 L.Ed.2d at 33 n.16. Nor is it a question of a right to a refund. For this Court has stated that retroactive application and due process in tax cases may require a refund subject to state procedural bars. *Id.* at ___ , 110 L.Ed.2d at 37-39. While retroactive application in a tax case may result in a refund, it does not follow that because a refund is conceded retroactive application has been decided or is implied. The point is that before Due Process issues are considered, a determination must be made of the distinct issue of retroactivity, the only question before this Court in the present case.

A pertinent example of the nonretroactivity question is the situation encountered by a state taxing authority relying on past precedent. For instance, in *Smith*, Arkansas relied on a line of cases that indicated its HUE tax was valid. A similar tax was unexpectedly defeated in *American Trucking Ass'ns v. Scheiner*, 483 U.S. 216 (1987). This Court determined that Arkansas should not be subject to *Scheiner* for taxes imposed prior to that decision. It also determined that sufficient protection of the taxpayers' commerce clause interests could

be accomplished by prospective relief. The only taxes subject to *Scheiner* were those in which the taxable event occurred after the case was decided. *Smith* at ___ , 110 L.Ed.2d at 173.

In the instant case, Amicus and Virginia both enacted taxes consistent with Federal law prior to *Davis*. The taxes were not enacted in ignorance of Federal law, but were instead based upon the body of law in this area that would lead to a different conclusion. *Davis* not only broke a trend, but also left the retroactivity issue open. Furthermore, the *Davis* opinion only said that Michigan had conceded a refund; it did not make a ruling on retroactivity.

In response to *Davis*, Respondent and Amicus removed the now unconstitutional provisions and inserted provisions that were nondiscriminatory by *Davis* standards. *See* 1989 Ark. Acts 27 (3d Ex. Sess.); 1989 Va. Acts c. 3 (Spec. Sess. II). When a state has attempted to follow federal law in good faith and retroactive application is not implicitly or explicitly discussed in the precedent-setting case, review of the choice of law between retroactive and prospective application must be made.

II. Based on the tests set forth in *Chevron Oil Co. v. Huson*, *Davis* should not be applied retroactively.

Once it is established that retroactivity may not be applicable, it is necessary to analyze the case under the tests enumerated in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) ("Chevron"). This narrow test is based upon three factors which properly define the limits of nonretroactivity.

A. *Chevron* Factor Number One

The first *Chevron* factor focuses on whether "new" law

was developed by the prior decision. Amicus does not wish to elaborate further on the argument submitted by Respondent, but acknowledges its complete agreement that the *Davis* decision created a "new" rule.

B. *Chevron* Factor Number Two

The second factor places the constitutional concept in historical perspective to promote a consistent body of law. As stated by the *Chevron* Court,

> In determining whether a decision should be given nonretroactive application, the Court must weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation.

404 U.S. at 106-07.

To analyze the second factor in this case, intergovernmental tax immunity must be discussed. The *Davis* discussion of this concept is informative. While the majority points to the waiver of jurisdiction in 1939 by the Public Salary Tax Act and the concurrent development of the constitutional doctrine of intergovernmental tax immunity, the dissent focuses on prior interpretation of the Act and related acts which are pertinent here. 489 U.S. at 818-828 (Stevens, J.). The point of the dissent is that prior law indicates that Virginia's interpretation of the nondiscrimination provision was correct. This seems plausible in light of the winding road of interpretation that characterizes intergovernmental tax immunity doctrine. *See Id.* The uncertainty and prior decisions demonstrate how Virginia, like other states, attempted to comply with federal law. Only when the *Davis*

decision was rendered did a constitutional violation appear.

In *Davis*, this Court stated that intergovernmental tax immunity has as its goal "legitimate state taxation." 489 U.S. at ___ . A tax is not, however, legitimate because it is enacted by a state. The tax must also be nondiscriminatory. Virginia, like other states, followed the former interpretation in enacting and enforcing a constitutionally valid statute. When the law became unconstitutional, the Virginia Legislature, like the Arkansas General Assembly, moved with deliberate speed to remove the invalid provision. *See* 1989 Ark. Acts 27 (3d Ex. Sess.) (enacted Nov. 6, 1989). Like Virginia's, Arkansas' law applies to income tax years beginning with the year of the *Davis* decision. *Id.* Under the law at the time the taxable event occurred, the taxes were valid and at least appeared by reasonable interpretation to be nondiscriminatory.

Petitioners suggest that prospective application will inhibit intergovernmental tax immunity by encouraging states to adopt unconstitutional taxes. This conclusion is untrue for many reasons. First, state agencies are generally required by state law to uphold the Constitution of the United States. This requirement is not without meaning. Second, cases such as this occupy state resources that could be used for other purposes. In the interest of efficiency, states are encouraged to avoid lawsuits. Finally, the financial uncertainty created by the prospect of refunding millions of dollars already discourages enacting unconstitutional taxes. Most states don't have money to use on extra refunds and would prefer to be secure in the knowledge that taxes collected and used now will not have to be offset by tax dollars collected later. The myth of the greedy, overbearing government is historical and not applicable in modern situations. In this case, it is especially untrue.

The intergovernmental tax immunity doctrine will not be advanced by retroactive application of *Davis*. In addition, retroactive application, in balance, will subvert the purposes of intergovernmental tax immunity.

C. *Chevron* Factor Number Three

The third prong of the *Chevron* test involves equitable considerations. This Court has stated "[w]here equitable considerations of the Court produce substantial inequitable results if applied retroactively, there is ample basis for avoiding the injustice or hardship by a holding of non-retroactivity." 404 U.S. at 107. Equitable considerations have an appropriate and not insignificant role in the decision. *Smith* at ___ , 110 L.Ed.2d at 161-62. As Justice O'Connor stated in *Smith*:

> [T]he threshold determination whether a new decision should be applied retroactively is a crucial one, requiring a hard look at whether retroactive application would be unjust. At this initial stage, the question is not whether equitable considerations outweigh the obligation to provide relief . . . , but whether there is a constitutional obligation in the first place. *Id.* (citation omitted).

Prior to Act 683 of 1975, the first $6,000 of annuities received from any federal retirement system or any state, county, municipal or school district retirement system in the State of Arkansas was exempt from income tax. 1975 Ark. Acts 683. Act 683 expanded the $6,000 exemption to include annuities received by Arkansas residents from state, county, municipal and school district retirement systems in other states. Act 683 went one step further. It provided a total exemption from Arkansas' income tax of all annuities

received by retirees from the Arkansas Teachers Retirement System. This was intended as an incentive for Arkansas teachers, who historically have received smaller salaries than teachers in other states, to remain in the state and in their chosen profession.

In 1977, Act 793 made benefits received from a state named plan and from the Arkansas State Highway Retirement System fully tax exempt. 1977 Ark. Acts 793. The purpose was to encourage poorly compensated state employees to remain in state government.

It should be pointed out that the first $6,000 of compensation received by members of the armed services of the United States has been exempt from Arkansas income tax since 1943. In addition, the first $6,000 of retirement benefits for armed services retirees was exempt.

In *Streight v. Ragland*, 280 Ark. 206, 655 S.W.2d 459 (1983), the Arkansas Supreme Court upheld the constitutionality of state income tax exemptions on the retirement income of federal, state, county and municipal retirees. Six privately retired taxpayers sought to have their state income tax on a privately sourced retirement income declared an illegal exaction or the exemptions (both the $6,000 and 100 percent exemptions) declared unconstitutional under the equal protection clause. Applying the rational basis test, the Special Chancellor indicated that

> the legislature may have sought to encourage entry into public service by granting the challenged tax exemptions.

Id. at 464. The Special Justice pointed out that *Streight* did not question the fact that exemptions were given to federal civil

service and military retirees as well as state employees. In other words, why would the state grant exemptions to federal employees? No question was raised concerning the disparate treatment between federal employees ($6,000 exemption) and state employees (full exemption). No mention was made of the intergovernmental immunity doctrine.

Changes to the exemption statutes occurred again in 1985, 1987 and in 1989 (both prior and subsequent to the decision in *Davis*). In 1985, the $6,000 exemption was extended to include retirement benefits received from "any employment related retirement system, plan or program", i.e. the exemption now applied to private retirement plans (1985 Ark. Acts 486). (Although Arkansas prevailed in *Streight*, it did not act as the greedy, overbearing government as Petitioners suggest would happen.) Act 521 of 1987 provided that residents who received both military retirement pay and other retirement or disability benefits prior to January 1, 1985 are entitled to two $6,000 exemptions (1987 Ark. Acts 521). Again, military employees received an advantage over civilian employees. Act 512 of 1989 extended the deadline from retiring under the Teacher Retirement System for purposes of exemption from income tax from December 31, 1989 to July 1, 1990 (1989 Ark. Acts 512).

Davis was decided March 28, 1989, and the complaint in *Pledger* was filed March 31, 1989.

A special session of the Arkansas legislature was convened and on November 6, 1989, Governor Bill Clinton signed into law Act 27, which was applicable to all income years beginning on or after January 1, 1989. This Act discontinued the total tax exemption for Arkansas state retirement benefits, and gave a $6,000 exemption to all who received benefits from retirement plans.

Although after *Davis*, one might conclude that Arkansas law discriminated against federal retirees, the facts are that state retirees received little, if any, preferential tax treatment.

In 1987, 18,123 state employees reported on their Arkansas individual income tax returns $111,493,321 in retirement benefits, an average of $6,152 per person. Of those state employees 9,995 (in excess of 50% of the total state retirees) received less than $6,000, the amount of the exemption received for federal and other retirement benefits. These amounts are somewhat higher than normal due to incentives given by the state for early retirement in 1987. Approximately 32,000 federal retirees file Arkansas returns, or 3.4% of individual income tax return filers.

A potential loss of $44.7 million (the projected refund as of May 15, 1992) in the Net Available for Distribution under Arkansas 1993 Fiscal Year's Revenue Stabilization Law Allocations would result in dramatic reductions in the financing of the state's public education system, service delivery in the state's Medicaid program, opening of critical new correctional units and in financing current pay plans levels for state employees.

The Arkansas Constitution requires a balanced budget, and revenue shortfalls in fiscal year 1992 resulted in drastic cuts in key areas, including layoffs of employees. From a practical standpoint, such a reduction in the 1993 fiscal year would offer particular hardship since it would be falling on the heels of reductions made during the 1992 fiscal year.

Reductions in general revenue also result in financial loss to the state in the form of lost federal and other matching dollars. For example, if the loss of $4.3 million in general revenue in the Department of Human Services were taken in

the state's Medicaid program, there would be a compounded loss of almost $13 million in federal matching funds.

A specific formula is in place, under Revenue Stabilization Law Allocations, which determines what funds will be reduced. If $44.7 million is required to be paid out of the 1993 fiscal year budget, reductions would be as follows:

Public School Fund	$27,767,476
General Education Fund	205,637
Human Services Fund	4,261,199
State General Gov't Fund	1,473,967
Other Funds	2,881,100
Inst's of Higher Education	8,107,421
TOTAL	$44,696,801

Arkansas and other states are already experiencing difficulty in the Medicaid area due to certain federal mandates. As previously indicated, a refund of this magnitude hits in more than one area. The Medicaid budget and matching funds are both severely decreased.

Petitioners assert that their interests in relief outweigh any interest the state might have in prospective application. It is true that Petitioners have some interest in receiving monetary relief personally, but they cannot assert that they are acting on behalf of the federal government. This is not a requirement for intergovernmental tax immunity, but it is asserted as an equitable consideration favoring petitioner. Even if they could, the benefit in the form of enhanced federal income tax revenues cannot be determined here and should not be considered in this case. Petitioners have already received a reprieve from the tax declared unconstitutional in *Davis*. It is not necessary nor feasible to subsidize this benefit

with a refund at the expense of other residents of the state. *See Smith* at ___ , 110 L.Ed.2d at 162-63, 173.

III. Remedies are determined by state law and prospective relief is constitutionally sufficient.

Davis did not mention retroactivity, and Michigan conceded that Davis was entitled to a refund. Davis indicated on his Michigan income tax returns that he was paying "under protest" the tax on federal retirement benefits. Under Michigan's 90-day statute of limitations on constitutional grounds for protesting tax liability, Davis was indeed entitled to a refund if the tax was determined unconstitutional.

Based upon the facts in *Davis*, it was not necessary for this Court to consider the retroactivity issue. Simply stated, Michigan law provided that Davis was entitled to a refund. Once this Court decided the constitutional issue, there was a further issue of remedies. Remedies are determined by state law not by this Court, and Michigan law provided that a refund was the appropriate remedy. The remedy, i.e. the refund, was not decided by this Court. Justice Souter in his opinion in *Beam*, stated:

> Nothing we say here deprives respondent of his opportunity to raise procedural bars to recovery under state law or demonstrate reliance interests entitled to consideration in determining the nature of the remedy that must be provided, a matter with which *McKesson* did not deal.

Id. at 115 L.Ed.2d 494.

As this Court held in *McKesson*, if there is a pre-payment opportunity to object to a tax, due process does not

require post-payment remedies. Virginia and Amicus have such in place, and refunds are not required under those state laws.

In addition to Justice Souter's comment in *Beam*, this Court has addressed the importance of settled expectations and reliance interests recently in *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992) and *Allied-Signal, Inc. v. Director*, 112 S.Ct. 2251 (1992). The states involved in post-*Davis* litigation have had statutes on their books for up to forty-five years. Federal retirees have had annual opportunities to challenge these statutes. The few challenges made to these statutes have been on equal protection grounds. The states have dealt fairly with these retirees over the years. Present and future generations should not be required to suffer the possible consequences of retroactivity when the states had no reason to question these taxation and exemption statutes. No one would venture to say that state legislatures should cease passing statutes, which they believe in good faith are constitutional, in order to avert the possibility that the statutes are unconstitutional. Settled expectations and reliance interests should be considered here, and the decision should be to apply *Davis* prospectively only.

CONCLUSION

Nonretroactive application is not normally a desired result. Nevertheless, when, as in this case, retroactive application violates the purposes of the underlying law and creates a substantial hardship, nonretroactivity effects justice. *Davis* was a big victory for federal retirees that should not be overextended. A just result in this case will only occur if the Virginia Supreme Court is affirmed, with appropriate action being taken in other cases, pending before this Court, including *Pledger v. Bosnick*.

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